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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1974

No. 74-1627

ARTHUR W. BROWN, Receiver - - Petitioner

versus

COMMONWEALTH OF KENTUCKY
E. G. ADAMS
ROBERT L. MUSSELMAN and
THOMAS G. FLORENCE - - - Respondents

PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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COMMONWEALTH OF KENTUCKY
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PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Petitioner, Arthur W. Brown, as Receiver of Prudential Building and Loan Association, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered on April 2, 1975.

OPINIONS BELOW

The opinion of the Court of Appeals for the Sixth Circuit, dated April 2, 1975, which is reported at 513 F. 2d 333, appears in Appendix B hereto. The opinions

of the District Court for the Western District of Kentucky, which are not reported, appear in Appendix E hereto.[1]

JURISDICTION

The judgment of the Court of Appeals was entered on April 2, 1975, and this petition for certiorari was filed within ninety (90) days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Whether jurisdiction lies in the Federal Courts over a suit for monetary relief against the Commonwealth of Kentucky for gross and willful violations by it of the Federal Securities Acts?

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional provisions involved in this Petition are the Supremacy Clause of, and the Eleventh Amendment to, the Constitution of the United States [App. A, p. 1a].

The statutory provisions involved in this Petition are the fraud sections of the Federal Securities Acts, specifically Section 17(a) of the Securities Act of 1933 (15 U.S.C. §77b) [App. A, p. 1a], Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j[b])

[1]The opinion of the District Court refers to an opinion in a companion class action case, alleging the same cause of action, styled *Leslie J. Barr* v. *Commonwealth of Kentucky*. The opinion in the *Barr* case appears in Appendix D.

[App. A, p. 3a] and Rule 10b-5 [App. A, p. 3a], promulgated by the Securities and Exchange Commission under Section 10(b) (herein referred to collectively as the "Federal Securities Acts").

STATEMENT OF THE CASE

This case raises a very serious question of conflict between the Eleventh Amendment and the Federal Securities Acts. The Eleventh Amendment[2] deprives the Federal Courts of jurisdiction to hear cases brought for monetary relief by a private citizen against a state. The Eleventh Amendment, therefore, is a very important obstacle to application of the Federal Securities Acts to the activities of the various states in the securities market. This Court has never ruled on this conflict; in view of the enormous and ever-growing amount of state activity in these markets, this Court should pass on the scope of federal regulation of such state activities. In two very recent decisions, *Employees* v. *Dept. of Public Health and Welfare,* 411 U. S. 279 (1973), and *Edelman* v. *Jordan,* 415 U. S. 651 (1974), this Court, in effect, overruled a prior decision,

[2]The Eleventh Amendment provides:

> The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.

The language of the Amendment has consistently been construed to bar suits by the state's own citizens as well as citizens of other states. *Hans* v. *Louisiana,* 134 U. S. 1 (1890); *Duhne* v. *New Jersey,* 251 U. S. 311 (1920); *Great Northern Life Insurance Co.* v. *Read,* 322 U. S. 47 (1944); *Parden* v. *Terminal R. Co.,* 377 U. S. 184 (1964); *Employees* v. *Department of Public Health and Welfare,* 411 U. S. 279 (1973); *Edelman* v. *Jordan,* 415 U. S. 651 (1974).

Parden v. *Terminal R. Co.*, 377 U. S. 151 (1964), and has made its position clear that this jurisdictional limitation will be strictly applied and suits will be entertained only in the most extraordinary circumstances. We believe those extraordinary circumstances exist in this case. Moreover, even if this case does not fall within this Court's test under the Eleventh Amendment, we believe the Court should reassess that test. If the Court allows the judgment to stand, then it will have created the very antithesis of Anglo-American jurisprudence—a right without a remedy.[3]

Petitioner, as Receiver of Prudential Building and Loan Association (hereinafter "Prudential"), brought this action against the Commonwealth of Kentucky, its former Banking Commissioner and the two state examiners who audited Prudential's books, asserting federal jurisdiction under the Federal Securities Acts. The acts complained of are fraud in connection with the Commonwealth's audit of Prudential, and the withholding of information from the investing public. In *Techerepnin* v. *Knight*, 389 U. S. 332 (1967), this Court held that deposits (or "shares") in a state-

[3]As this Court stated in *Parden:*

> It would surprise our citizens, we think, to learn that petitioners, who in terms of the language and purposes of the FELA are on precisely the same footing as other railroad workers, must be denied the benefit of the Act simply because the railroad for which they work happens to be owned and operated by a State rather than a private corporation. It would be even more surprising to learn that the FELA does make the Terminal Railway "liable" to petitioners, but, unfortunately, provides no means by which that liability may be enforced. Moreover, such a result would bear the seeds of a substantial impediment to the efficient working of our federalism. 377 U. S., at 197.

chartered savings and loan association constitute "securities," and there has been no dispute in this action that the depositors of Prudential did in fact purchase "securities."

The Commonwealth moved to dismiss for lack of jurisdiction, citing *Employees*. Petitioner contended that the Commonwealth had waived its jurisdictional immunity under the law as enunciated in *Parden*. The District Court dismissed as to the Commonwealth and the Sixth Circuit affirmed. The District Court overruled a motion to dismiss the individual defendants and they did not participate in the appeal in the Sixth Circuit. We believe a review of this case will demonstate that dismissal of the Commonwealth was in error, and that this Petition should be granted.

In 1953 the Commonwealth of Kentucky issued a savings and loan association charter to H. M. Dunn, Sr. and H. M. Dunn, Jr. The Dunns commenced business as "Prudential Building and Loan Association." Almost from its inception, Prudential was grossly and fraudulently mismanaged. It became so bad that in 1958, when Prudential applied for approval to make federally insured and guaranteed mortgage loans, the Commonwealth's Commissioner of Banking, Earl B. Combs, wrote to the Federal National Mortgage Administration and stated that Prudential's application should be rejected because its "methods of operation are not entirely in accord with what we consider a bona fide savings and loan association" [App. E, p. 34a].

In 1961, the Commonwealth actually seized Prudential. Instead of closing Prudential, however, the Commonwealth operated Prudential. Within four (4) months, Prudential was turned back to the Dunns, who thereafter solicited and received millions of dollars of new deposits [App. E, p. 35a]. Almost as swiftly as the money was bilked from the public, it was siphoned into the Dunns' personal real estate projects.

Finally, in 1972, the Commonwealth closed Prudential. By that time the Dunns had loaned themselves over $20,000,000 of the depositors' money [Complaint, App. C, p. 13a]. The losses on these loans will be approximately $17,000,000. The Dunns have served over two years of five-year sentences for criminal violations of Kentucky's savings and loan statutes, and are currently serving federal sentences for income tax evasion.

Throughout its too-long history, Prudential was audited at least annually by the Commonwealth [KRS 289.710 (App. A, p. 5a)]. State-chartered savings and loan associations were charged a fee by the Commonwealth for this auditing function [KRS 289.730 (App. A, p. 6a)]. The results of the audit were secret and were not available to the investing public [KRS 289.710]. Throughout the period, therefore, the depositors had only one indication of Prudential's condition—the fact that the Commonwealth had examined Prudential and had not taken any action. The depositors relied upon the Commonwealth's examinations as a representation that Prudential was solvent and

being operated in a safe, sound manner. Nothing could have been farther from the truth.

The irregularities in Prudential's books were covered up by the Commonwealth's bank examiners. In payment for this service, the wife of one examiner received over $250,000 in "advertising" fees [App. A, p. 16a]. The Commonwealth withheld information from the investing public, violated its own criminal laws and committed fraud in violation of the Federal Securities Acts.

REASONS WHY THIS PETITION SHOULD BE GRANTED

If the lower courts are affirmed, the Federal Securities Acts will contain a strange anomaly—the state's employees will be liable for their stock fraud, but the entity which received the money will be able to retain the benefits with impunity.

We have found no case which by final judgment subjected a state to suit in Federal Court for fraud by it in the issuance of its securities. We have found only one other case involving other state activities in the securities market—*MacKethan* v. *Commonwealth of Virginia,* 370 F. Supp. 1 (E.D. Va. 1974). In that case the District Court dismissed for lack of jurisdiction under the Eleventh Amendment. The Fourth Circuit affirmed in a per curiam opinion. A petition for certiorari (No. 74-1198) is presently pending before this Court. *MacKethan* is remarkably similar to this action, and all arguments in that case apply here with equal force.

To our knowledge, these are the first cases to reach this Court on the issue of whether the Federal Courts have jurisdiction to hear cases against states arising out of their activities in the securities market.

The basic issue is the extent to which states may make representations to the investing public without fear of liability for their violations of the Federal Securities Acts. The recent financial crisis of the City of New York graphically demonstrates the problem. Had a default occurred on New York City's hundreds of millions of dollars of debt, there might well have been a cause of action under the Federal Securities Acts. Yet, under the lower court rulings here and in *MacKethan,* the creditors and security holders could not have sued the one entity which had the ability to compensate the losses—the government which had committed the fraud. Congress could not have been so blind as to wish such a monumental loss to be without a remedy.

This case and the *MacKethan* case are, therefore, ones of first impression, involve an issue of overriding public importance, and should be passed upon by this Court.

I.

Congress Has Expressed Its Intent That States Be Subject to the Fraud Provisions of the Federal Securities Law—There Is Jurisdiction Even Under *Employees* and *Edelman*

The District and Circuit Courts have erred in the application of the law; this Court should grant certiorari and reverse this grave miscarriage of justice.

The Eleventh Amendment to the United States Constitution deprives the Federal courts of jurisdiction to hear cases brought against a state by a citizen of the United States. In *Parden,* this Court held that a state could impliedly waive its jurisdictional immunity. In *Employees* and *Edelman,* the Court severely restricted the test for implied waiver. Even under the narrow test, however, implied waiver exists in this action.

Under *Employees* and *Edelman,* a state may be sued in Federal Court only if Congress has expressed a clear intent to subject states to federal jurisdiction. As stated by this Court in *Edelman* at page 672, the test is:

> The question of waiver or consent under the Eleventh Amendment was found in those cases (*Parden, Employees* and other citations therein) to turn on whether Congress had intended to abrogate the immunity in question, and whether the State by its participation in the program authorized by Congress had in effect consented to the abrogation of that immunity.
>
> * * *
>
> Constructive consent is not a doctrine commonly associated with the surrender of constitutional rights, and we see no place for it here. In deciding whether a State has waived its constitutional protection under the Eleventh Amendment, we will find waiver only where stated "by the most express language or by such overwhelming implications from the text as [will] leave no room for any other reasonable construction." *Murray* v. *Wilson Distilling Co.,* 213 U. S. 151, 171 (1909).

Section 17(c) of the 1933 Act specifically provides that exemptions set forth in Section 3 of the Act (including an exemption for state activity) do not apply for purposes of the fraud provisions. Section 2(2) of the 1933 Act specifically includes "a government or political subdivision thereof" in the definition of "person." Hence, the 1933 Act is quite specific in applying Section 17(a) to state governments. Similarly, there are no exemptions of government activity in Section 10(b) of the Exchange Act.

In view of the specific coverage in the 1933 Act and of the lack of any exemption in the 1934 Exchange Act, the only "reasonable construction" is that Congress has expressed its intent "by the most express language," and by "overwhelming implications" that states be subject to the fraud provisions of the Federal Securities Acts.[4]

[4]While this Court has not passed on the issue, lower courts have consistently held that securities issued by state and local governments are subject to the fraud provisions. *See, SEC* v. *Charles A. Morris & Associates, Inc.*, 1972-73 CCH Sec. L. Rep., ¶93,756 at 93,303 (W.D. Tenn. 1973); *Int. Ladies Garment Workers Union* v. *Shields & Co.*, 209 F. Supp. 145, at 147 (S.D. N.Y. 1962); *Baron* v. *Shields*, 131 F. Supp. 370, at 372 (S.D. N.Y. 1954); *Texas Continental Life Ins. Co.* v. *Dunne*, 307 F. 2d 242 (6th Cir. 1962).

The Securities Act Amendments of 1975 (Senate Bill 249), signed by President Ford in May, 1975, further express the concern of Congress with state activity in the securities market. For the first time, the Securities and Exchange Commission has been given jurisdiction over brokers dealing solely in state-issued securities. The abuses by states and by other parties acting for states or dealing in state-issued securities have been so numerous and so severe that Congress has increased the direct federal regulation of the brokers involved.

The Securities and Exchange Commission has made clear its position that state and local securities are subject to the fraud provisions; it recently asserted jurisdiction over a revenue bond issue, and successfully sought an injunction against persons involved in the issue, *SEC* v. *The Senex Corp., et al.*, No. 74-53 (E.D. Ky. 1975).

It is extremely important to note that the activity complained of here—auditing—would subject a private party to liability.[5] In *Parden* this Court pointed out the difficulty in allowing a state to engage in acts with impunity while private parties could be sued:

> States have entered and are entering numerous forms of activity which, if carried on by a private person or corporation, would be subject to federal regulation. In a significant and increasing number of instances such regulation takes the form of authorization of lawsuit by private parties. To preclude this form of regulation in all cases of state activity would remove an important weapon from the congressional arsenal with respect to a substantial volume of regulable conduct. 377 U. S., at 197-198.

The Commonwealth should not be allowed to engage in a proprietary auditing business without subjecting itself to the same liability imposed on private auditors. To do so would seriously undermine the prophylactic effect of the Federal Securities Acts.

Congress has specifically provided that states are subject to the Federal Securities Acts; the *Employees-Edelman* test has been satisfied. This Court should grant certiorari and reverse the Sixth Circuit.

[5]*Competitive Associates, Inc.* v. *Laventhal, Krekstein, Horwath & Horwath*, ____ F. 2d ____, 1975 CCH Sec. L. Rep., ¶95,090 (2d Cir. May 8, 1975); *Blakely* v. *Lisac*, 357 F. Supp. 255 (D.C. Ore. 1972); *Herzfeld* v. *Laventhal, Krekstein, Horwath & Horwath*, 73-74 CCH Sec. L. Rep. ¶94,574 (S.D. N.Y. 1974).

II.

This Court Should Reassess Its Treatment of the Eleventh Amendment Under *Employees* and *Edelman*

If the Court should conclude that the *Employees-Edelman* test has not been satisfied, then Petitioner will indeed have a right without a remedy. Under state remedies, the Petitioner could not bring suit in court and obtain a trial by jury. Rather, he would be relegated to an administrative proceeding before the Board of Claims of Kentucky [KRS 44.070, App. A, pp. 4a-5a]. Individual recoveries are limited to $20,000, and liability is limited to acts of negligence, thereby depriving a substantial number of investors of a full and complete restitution. If these federal rights are to be enforced at all, they must be enforced in the United States District Courts.

The test under *Employees* and *Edelman* looks to the intent of *Congress* to find a *waiver* by the *state*. We respectfully submit that *Employees* and *Edelman* tend to confuse the test of waiver under the Eleventh Amendment with the test of whether a state is subject to federal jurisdiction under the Supremacy Clause. The *Employees-Edelman* test is totally appropriate under the Supremacy Clause; there the test is the intent of Congress in overriding a competing state interest. Under the Eleventh Amendment, however, the sole question is waiver. Waiver is a voluntary act; the test should look to the actions of the *state*, not of Congress.

The Court should re-examine *Employees* and *Edelman* and should establish a new test to determine the

existence of waiver. Under a proper test the waiver must arise from some voluntary act by the state, not from the intent of Congress. Congress cannot waive a state's right; only the state can do that.

We believe waiver has occurred here. The errant state activity is the accounting function performed by the Commonwealth in conducting examinations of Prudential. We emphasize that we are *not* complaining of the exercise by the Commonwealth of its regulatory powers over savings and loan associations or over securities. Rather, we contend that by voluntarily conducting its own examinations, an activity which just as easily could have been performed by a private accountant, the Commonwealth waived its Eleventh Amendment protection.

The voluntary nature of the Commonwealth's actions are clear. In 1964, the entire savings and loan statute was revised and rewritten [1964 Ky. Acts, Chapter 138]. Secret examinations were continued in the new statute. This action was taken *after* Prudential had been seized by the Commonwealth and later returned to its management. After Prudential failed, the Commonwealth took a step which will eliminate state auditing: all such associations are now required to have deposit insurance with the Federal Savings and Loan Insurance Corporation, thereby shifting the auditing to the Federal Government [KRS 289.024, 289.451, 289.461]. If only the Commonwealth had done this earlier, Prudential's depositors would have saved millions of dollars. Instead, the Common-

wealth voluntarily erected a shield—secret state auditing—behind which the Dunns could hide the truth. By doing so, the Commonwealth represented to each depositor that Prudential was a sound investment. This voluntary deception waived the Commonwealth's rights under the Eleventh Amendment.

We respectfully submit that the focus of the Court's attention under the Eleventh Amendment should be on the state, not on Congress. The *Edelman* test is appropriate under the Supremacy Clause. Where, however, a state voluntarily conducts an auditing business for a fee, and thereby represents to the investing public that an institution is sound, the state has by its own hand waived its Eleventh Amendment immunity.

CONCLUSION

Even under the strict test of the *Employees* and *Edelman* cases, the Congress has expressed an intent that citizens have a federal remedy to enforce their federal rights under the Federal Securities Acts. Even if the Court should conclude that the *Employees-Edelman* test has not been met, the Court shoud reassess its holdings in *Employees* and *Edelman,* for their effect would be to create a right without a remedy. If the dismissal stands, then Prudential's 11,000 investors will be in just such a position. They will have suffered grievous loss as a result of a massive fraud in flagrant violation of the Federal Securities Acts. Yet, they will have no forum in which to vindicate their federal rights. They will, indeed, have a right without a

remedy. The Court should grant the writ and hear this case on the merits.

Respectfully submitted,

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APPENDIX

APPENDIX A

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28 U.S.C. § 1254(1)

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

Supremacy Clause, Art. VI, C 1.2, United States Constitution

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Eleventh Amendment, United States Constitution

The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State.

SECURITIES ACT OF 1933
15 U.S.C. § 77a, *et seq.*

Section 2(2) [15 U.S.C. § 77b(2)]

The term "person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or

political subdivision thereof. As used in this paragraph the term "trust" shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security.

Section 3(a)(2) [15 U.S.C. § 77c(a)(2)]

(a) Except as hereinafter expressly provided the provisions of this title shall not apply to any of the following classes of securities:

* * * * * * *

(2) Any security issued . . . by any State of the United States, . . .

Section 17 [15 U.S.C. § 77q]

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a

security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 3 [§ 77c of this title] shall not apply to the provisions of this section.

Section 22(a) [77 U.S.C. § 77v(a)]

The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter.

. . .

SECURITIES EXCHANGE ACT OF 1934

15 U.S.C. § 78a, *et seq.*

Section 10(b) [15 U.S.C. § 78j(b)]

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 27 [15 U.S.C. § 77aa]

The district courts of the United States, the district court of the United States for the District of Columbia and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder.

. . .

Rule 10(b)-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

KENTUCKY REVISED STATUTES, CHAPTER 289

KRS 44.070—(1) A board of claims, composed of the members of the workmen's compensation board as hereinafter provided, is created and vested with full power and authority to investigate, hear proof, and to compensate persons for damages sustained to either person or property as a proximate result of negligence on the part of the commonwealth, any of its departments or agencies, or any of its officers, agents or employees while acting within the

scope of their employment by the commonwealth or any of its departments or agencies; Provided, however, regardless of any provision of law to the contrary, the commonwealth, its departments and agencies, and its officers, agents and employees, while acting within the scope of their employment by the commonwealth or any of its departments or agencies, shall not be liable for pain or suffering, and compensation shall not be allowed, awarded, or paid for pain or suffering. Except as hereinafter provided the board shall be independent of all agencies and departments of the commonwealth except as provided in KRS 44.070 to 44.160.

(2) The board shall be composed of five (5) attorneys who are members of the workmen's compensation board and who have been appointed and hold office under the provisions of KRS 342.215 and 342.220. The members shall not be entitled to additional compensation for their services on the board of claims.

(3) The governor shall designate a member of the board to serve as chairman for a term of four (4) years. Any vacancy in the chairmanship shall be filled by the governor. No member shall, at the same time, serve as chairman of the workmen's compensation board and as chairman of the board of claims.

(4) The executive secretary, referees and employees of the workmen's compensation board, without additional compensation, shall be ex officio the executive secretary, referees and employees respectively, of the board of claims.

(5) Regardless of any provision of law to the contrary, the jurisdiction of the board is exclusive, and a single claim for the recovery of money or a single award of money shall not exceed twenty thousand dollars ($20,000), exclusive of interest and costs.

KRS 289.710. Examination of associations—Report—Information confidential.—(1) The affairs of every associa-

tion not in liquidation shall be examined by the commissioner or an examiner of the commissioner as often as is deemed necessary, and at least once in every year, without any notice to the association, its officers or agents. The examiner shall make a thorough examination into the condition, workings and affairs of the association. All books, papers and records and assets of the association shall be subject to his inspection.

(2) The examiner shall file a report of his findings in the office of the commissioner and the commissioner shall furnish a copy of such report to the association examined. The examiner shall report any violation of law or any unauthorized or unfit practices or any failure to keep and have correct amounts of business of the association, and if he finds that any director has wilfully neglected to attend meetings regularly, he shall recommend the discharge of such director.

(3) No examiner acting under the provisions of this chapter shall disclose to any person, other than officially to the commissioner, in the report made to him or in compliance with the order of some court, the names of stockholders or members in any association, or any information respecting their private accounts.

(4) All reports and information in the hands of the commissioner concerning federal associations, or federally insured associations, shall be subject to inspection by the federal home loan bank and the federal home loan bank board and their authorized representatives. (Enact. Acts 1964, ch. 138, § 52.)

KRS 289.730. Filing fee for reports—Examination fees. —(1) Each report required of associations by this chapter shall be made to the commissioner and the association making the report shall pay to the commissioner a filing fee of two dollars ($2.00).

(2) Each association shall pay the following fee to the commissioner immediately upon completion of its examination:

(a) Associations having assets of twenty thousand dollars ($20,000) or less shall pay twenty dollars ($20.00);

(b) Associations having assets of over twenty thousand dollars ($20,000) but less than fifty thousand dollars ($50,000) shall pay twenty-five dollars ($25.00);

(c) Associations having assets of fifty thousand dollars ($50,000) but not over one hundred thousand dollars ($100,000) shall pay thirty-five dollars ($35.00);

(d) Associations having assets of more than one hundred thousand dollars ($100,000) shall pay thirty-five dollars ($35.00) for the first one hundred thousand dollars ($100,000) and five dollars for each additional one hundred thousand dollars ($100,000) or fraction thereof.

(3) No association shall be required to pay for more than one (1) examination each year, unless such examination is necessary because of the association's failure to file reports required by this chapter. (Enact. Acts 1964, ch. 138, § 62; 1968, ch. 190.)

APPENDIX B

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

ARTHUR W. BROWN, Receiver,
Plaintiff-Appellant,
v.
THE COMMONWEALTH OF KENTUCKY,
Defendant-Appellee.

ON APPEAL from the United States District Court for the Western District of Kentucky.

Decided and Filed April 2, 1975.

Before: MILLER, LIVELY and ENGEL, Circuit Judges.

PER CURIAM. This appeal presents the sole issue of whether the Eleventh Amendment[1] to the Constitution protects the Commonwealth of Kentucky from suit by one of its citizens[2] for damages resulting from alleged violations by its officials of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j), Rule 10 b-5, 17 C.F.R.

[1]The Eleventh Amendment provides:

"The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State".

[2]The language of the Amendment has consistently been construed to bar suits by the state's own citizens as well as citizens of other states. *Hans* v. *Louisiana*, 134 U. S. 1 (1890); *Duhne* v. *New Jersey*, 251 U. S. 311 (1920); *Great Northern Life Insurance Co.* v. *Read*, 322 U. S. 47 (1944); *Parden* v. *Terminal R. Co.*, 377 U. S. 184 (1964); *Employees* v. *Department of Public Health and Welfare*, 411 U. S. 279 (1973); *Edelman* v. *Jordan*, 415 U. S. 651 (1974).

240.10b-5 and Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77(q).[3] The District Court held that such a

[3]Section 17 of the Securities Act of 1933 provides:

§ 77q. Fraudulent interstate transactions

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

May 27, 1933, c. 38, Title I, § 17, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 10, 68 Stat. 686.

Section 10(b) of the Securities Exchange Act of 1934 provides:

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commis-

(Footnote continued on following page)

suit against the state was barred and dismissed the action against the Commonwealth accordingly. We affirm.

Plaintiff Arthur W. Brown was appointed by the Jefferson County Circuit Judge as a Receiver of Prudential Building and Loan Association, an insolvent Louisville savings and loan association organized under Kentucky law. Plaintiff sought to recover for the Association's members, creditors and depositors some $23,000,000 in damages, charging that this amount was lost through the fraudulent or grossly negligent failure of the Commissioner of Banking and Securities and certain named loan examiners employed by that department to discover the mismanagement and unlawful self-dealings of the president and certain officers of the Association over a four year period.

Under Kentucky Revised Statutes 289.710, the Commissioner of Banking and Securities, or an examiner, is required annually and without notice to "make a thorough examination into the condition, workings and affairs of the association," K.R.S. 289.710(1), and to "report any violation of law or any unauthorized or unfit practices or any failure to keep or have correct amounts of busines of the association . . .", K.R.S. 289.710(2). The complaint specifically alleged that one of the state loan examiners indirectly accepted payments from Prudential for services purportedly performed by the examiner's wife in violation of K.R.S. 289.690. That statute forbids an examiner, directly or indirectly, from receiving any payment, compen-

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sion may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

June 6, 1934, c. 404 § 10, 48 Stat. 891.

sation or gratuity from any association. It was further charged that ". . . no reasonable person could have made any kind of examination of Prudential without discovering and reporting the many improper and illegal acts and omissions of Prudential management." Accordingly, it was alleged, by such gross neglect of its statutory duty to inspect, the Commnowealth permitted the Association to become insolvent.

In *Tcherepnin* v. *Knight*, 389 U. S. 322 (1967), the Supreme Court held that capital shares of a state chartered savings and loan association are "securities" within the meaning of Section 10(b) of the Securities Exchange Act of 1934. On this basis, plaintiff claimed that the failure to discover and disclose the insolvency of the Association amounts to "a failure to disclose under the Exchange Act" warranting the invocation of the District Court's federal question jurisdiction, 28 U.S.C. §§ 1331, 1337, 15 U.S.C. §§ 78(aa) and 77(v).

In *Parden* v. *Terminal R. Co.*, 377 U. S. 184 (1964) the Supreme Court held that by its operation of a common carrier railroad in interstate commerce, the State of Alabama waived its sovereign immunity and consented to a suit brought in federal court by employees of the railroad under the Federal Employers' Liability Act. While observing that "It remains the law that a State may not be sued by an individual without its consent," 377 U. S. at 192, *Parden* nevertheless held that consent was necessarily granted by Alabama when it entered into the interstate railroad business approximately 20 years after the enactment of the FELA. In like manner, urges the receiver here in the 1933 and 1934 Acts "Congress has enacted a comprehensive scheme of laws regulating the sales of securities and has given exclusive jurisdiction to the federal courts to hear such actions." Thus, he argues, by interposing itself completely in the affairs of Prudential and hence, at least since *Tcherepnin*, a sphere of activity subject to concurrent fed-

eral regulation, the Commonwealth of Kentucky must therefore be deemed to have waived its immunity to suit.

Whatever doubts may have been raised concerning the continuing viability of the immunity doctrine under the Eleventh Amendment after *Parden* v. *Terminal R. Co., supra,* have been since laid to rest by *Employees* v. *Missouri Public Health Dept.,* (sic) 411 U. S. 279 (1973) and *Edelman* v. *Jordan,* 415 U. S. 651 (1974). As pointed out in *Edelman,* "The question of waiver or consent under the Eleventh Amendment was found in those cases (*Parden, Employees* and other citations therein) to turn on whether Congress had intended to abrogate the immunity in question, and whether the State by its participation in the program authorized by Congress had in effect consented to the abrogation of that immunity." *Edelman* v. *Jordan, supra,* at 672.

Our examination of both the Securities Act of 1933 and the Securities Exchange Act of 1934 totally fails to reveal "a purpose of Congress to make it possible for a citizen of that State or another State to sue the State in the federal courts." *Employees* v. *Missouri Public Health Dept., supra,* (sic) at 285. Here the statutory duty imposed upon the Kentucky Commissioner of Banking and Securities cannot in any way be construed as the exercise of a proprietary function, but is rather clearly the exercise of a regulatory function of the state over its own chartered institutions which has been historically exercised as part of its governmental powers. There is noting to suggest that either federal act was intended to be or should be construed either to divest the Commonwealth of Kentucky of the power to regulate its state chartered institutions or beyond that, to do so only upon condition of its consent to be sued by one of its own citizens if that power is for any reason improperly exercised. *Edelman* v. *Jordan, supra,* made it manifestly clear that:

> Constructive consent is not a doctrine commonly associated with the surrender of constitutional rights, and we see no place for it here. In deciding whether a State has waived its constitutional protection under the Eleventh Amendment, we will find waiver only where stated "by the most express language or by such overwhelming implications from the text as [will] leave no room for any other reasonable construction." *Murray* v. *Wilson Distilling Co.,* 213 U. S. 151, 171 (1909).

In this case, plaintiff has sought money damages from the Commonwealth itself. No injunctive or other merely prospective relief has been sought. Cf. *Ex Parte Young,* 209 U. S. 123 (1908). Recovery, if any, will come from the state treasury. This, we think, is the clearest type of case in which the Eleventh Amendment bar against suit protects the state. Accordingly, since we find no waiver of the Amendment, the judgment dismissing the Commonwealth of Kentucky as a defendant in the above entitled cause is affirmed. Costs to appellees.

APPENDIX C

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF KENTUCKY
AT LOUISVILLE

No. 7635-B

ARTHUR W. BROWN, Receiver of
Prudential Building and Loan Association
530 West Jefferson Street
Louisville, Kentucky 40202 - - - *Plaintiff*

v.

COMMONWEALTH OF KENTUCKY, ET AL. - *Defendants*

COMPLAINT—Filed 3/30/73

Comes now the Plaintiff, Arthur W. Brown, in his capacity as Receiver of Prudential Building and Loan Association (hereinafter "Prudential"), by counsel, and for his cause of action herein states as follows:

COUNT I

1. Plaintiff is the duly appointed, qualified and acting receiver of Prudential, a savings and loan association organized and existing under Chapter 289 of the Kentucky Revised Statutes, and having its place of business at 530 West Jefferson Street, Louisville, Kentucky. Plaintiff was appointed Receiver by an order entered on April 18, 1972, in Civil Action No. 160318, currently pending in the Chancery Branch, First Division, Jefferson Circuit Court, Commonwealth of Kentucky, styled Lenvil R. Hall, Commissioner vs. Prudential Building and Loan Association, et al. As Receiver, Plaintiff is the proper representative of Prudential, its creditors and members and the proper party to prosecute all claims for and on behalf of Prudential, its members and creditors.

2. Defendant E. G. Adams was the duly appointed, qualified and acting Commissioner of Banking and Securities of the Commonwealth of Kentucky during the period December, 1967, to September, 1971.

3. At all times relevant herein, the Defendants Robert L. Musselman and Thomas G. Florence were savings and loan examiners employed by the Defendant Commonwealth of Kentucky in its Department of Banking and Securities.

4. The capital shares, the passbook accounts and the certificates of investment issued by Prudential to its members are securities within the meaning of the Securities Exchange Act of 1934, 15 U.S.C. § 77a, et seq., and specifically within the meaning of Section 10(b) thereof and Rule 10(b)-5 promulgated thereunder, and this action is in behalf of Prudential and in behalf of all members who purchased such securities or who, owning such securities, failed to sell them or to withdraw from Prudential the funds represented by such securities. See Tcherepnin v. Knight, 389 U. S. 332, 88 S. Ct. 548, 19 L. Ed. 2d 564 (1967); Tcherepnin v. Franz, 461 F. 2d 544 (7th Cir., 1972).

5. The jurisdiction of this court is based upon 28 U.S. C.A. §1331 and §1337, §27 of Securities Exchange Act of 1934, 15 U.S.C.A. §78aa, §22 of the Securities Act of 1933, 15 U.S.C.A. §77v, and the principles of pendent jurisdiction insofar as so much of this action is based on state law.

6. The acts and transactions complained of herein were carried out in whole or in substantial part within the Western District of Kentucky.

7. During a period beginning in or about the year 1967 and ending on March 20, 1972, the Defendants Robert L.

Musselman and Thomas G. Florence were in charge of making the annual examinations of Prudential required by KRS 289.710 for the purpose of establishing that the affairs of Prudential were being conducted in accord with the provisions of KRS Chapter 289, and they did, in fact, conduct such examinations.

8. As such examiners, Defendants Musselman and Florence had a duty to conduct such examinations according to law and in a reasonable, workmanlike and non-negligent manner.

9. During the period beginning in or about the year 1967 and ending April 3, 1972, the affairs of Prudential were manifestly not being conducted in accord with the provisions of Kentucky Revised Statutes, Chapter 289, nor in accord with principles of sound and fit management. The officers and directors of Prudential committed many violations of the provisions of Chapter 289 which the examiners should have discovered and reported. During said period Prudential was manifestly insolvent and in an unsafe condition, and it was inexpedient to allow it to continue in business. By way of example but not by way of limitation, Prudential during this period lent in excess of $20,000,000.00 to various entities owned and controlled by H. M. Dunn, Sr., President of Prudential, and H. M. Dunn, Jr., Secretary-Treasurer of Prudential, without obtaining sufficient security, in many cases without obtaining recorded mortgages and notes, all contrary to the provisions of KRS Chapter 289, and there existed numerous other violations of Chapter 289 of the Kentucky Revised Statutes.

10. At various times during this period, Defendant Musselman violated KRS 289.690 by indirectly accepting payments from Prudential for services purportedly performed by his wife.

11. No reasonable person could have made any kind of examination of Prudential without discovering and report-

ing the many improper and illegal acts and omissions of Prudential's management.

12. Defendants Musselman and Florence either knew of said illegal, unfit and improper acts and omissions and did nothing about them, which constituted a fraud on the members and creditors of Prudential, or Defendants Musselman and Florence carelessly failed to discover and report the illegal, unfit and improper acts and omissions, which constituted willful and wanton negligence in the performance of their duties as examiners in the Department of Banking and Securities.

13. Defendant Adams, as Commissioner of Banking and Securities, had a duty to supervise the Defendants Musselman and Florence to insure that they perfomed their duties as examiners properly. Defendant Adams similarly had a duty as Commissioner of Banking and Securities to supervise the affairs of Prudential and to enforce the provisions of KRS Chapter 289 in relation to Prudential in order to prevent Prudential from being mismanaged. Adams grossly violated these duties or was negligent in the performance thereof and is, therefore, liable to Prudential, its members and creditors for damages arising therefrom.

14. As a direct and proximate result of the acts and/or omissions of Defendants Adams, Musselman and Florence, Prudential was carelessly permitted to become insolvent and its capital impaired.

15. The Defendant Commonwealth of Kentucky, by the enactment of KRS Chapter 289 has assumed the responsibility of supervising and regulating the affairs of savings and loan associations in the interest of protecting such associations, their members and creditors and preventing the insolvency and impairment of such associations. The Commonwealth of Kentucky, by and through its Department of Banking and Securities, and by and through the

Defendants Adams, Musselman and Florence, acting within the scope of their authority, was grossly negligent in enforcing the provisions of KRS Chapter 289 in relation to Prudential. This gross negligence proximately caused or permitted the insolvency of Prudential.

16. Those members of Prudential who purchased their securities after the above-described acts and/or omissions of Defendants Adams, Musselman and Florence and the Commonwealth of Kentucky, relied upon the fact that such examinations had been made and that said Defendants had the above-described duties, and were induced thereby to purchase said securities.

17. Because of the acts of fraud and negligence alleged above, members of Prudential who previously purchased its securities were induced not to sell these securities or to withdraw from Prudential the funds represented by such securities and thereby suffered damage to the extent of their losses.

18. The above named Defendants' failure to properly supervise, examine and enforce the provisions of KRS Chapter 289 constituted a course of conduct which operated as a fraud or deceit upon the members of Prudential, all in connection with the offer, purchase and sale of securities. Said fraud or deceit was carried out directly or indirectly by means or instrumentalities of and instruments of transportation or communication in interstate commerce or by the use of the United States mails.

19. The above named Defendants' conduct was in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j and Rule 10 b-5 promulgated thereunder, 17 C.F.R. 240.10 b-5, and further constituted a violation of §17(a) of the Securities Act of 1933, 15 U.S.C. 77q.

20. As a direct and proximate result of the acts and/or omissions of the Defendants Adams, Musselman and Florence and the Commonwealth of Kentucky, and each of

them, individually and collectively, Prudential and its members, depositors and creditors have suffered damages of and as yet undetermined amount, but on information and belief Plaintiff alleges the damages to be at least in the amount of $23,000,000.00.

21. Defendant Perry R. Miller is at the present time the Acting Commissioner of Banking and Securities of Defendant Commonwealth of Kentucky. Mr. Miller is a formal defendant only; Plaintiff does not allege or claim that Mr. Miller has performed any improper or negligent act. On the contrary, Mr. Miller has been active in discovering and exposing the negligent, fraudulent and wrongful acts and omissions alleged herein on the part of the other Defendants. Accordingly, no relief is sought against him. He is named as a defendant because, as Acting Commissioner, he is the duly constituted representative of the Commonwealth and, as such, he has a right to be heard regarding the issues presented herein.

COUNT II

22. Plaintiff herein incorporated and alleges as if fully set forth herein paragraphs 1, 2, 3, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 20 and 21 of Count I above.

23. The above described acts and/or omissions constituted common law fraud and/or negligence under the law of the Commonwealth of Kentucky.

Wherefore, Plaintiff prays for judgment as follows:

[a] A personal judgment against Defendants Adams, Musselman and Florence and the Commonwealth of Kentucky, jointly and severally, in the amount of $23,000,000.00 or for such other sums as the proof herein may show due, plus interest on said sum at the rate of six percent (6%) per annum from April 3, 1972, until paid;

[b] A reasonable attorneys fee in this action;

[c] Its costs expended herein; and

[d] Such further relief to which the Plaintiff might appear entitled.

(s) Arthur W. Grafton
(s) Stuart E. Lampe
(s) Parker W. Duncan
(s) James N. Williams, Jr.
Wyatt, Grafton & Sloss
300 Marion E. Taylor Building
Louisville, Kentucky 40202
Attorneys for Plaintiff

APPENDIX D

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF KENTUCKY
AT LOUISVILLE

No. 7637-B

LESLIE J. BARR, ET AL. - - - - *Plaintiffs*

v.

COMMONWEALTH OF KENTUCKY, ET AL. - *Defendants*

MEMORANDUM AND ORDER—Filed August 24, 1972

This purported class action was brought by holders of withdrawable capital shares in the now-insolvent Prudential and American Building and Loan Associations against the Commonwealth of Kentucky; Department of Banking and Securities of Kentucky; E. G. Adams, Commissioner for said Department from December 13, 1967, through December 6, 1971; and Robert L. Musselman and Thomas G. Florence, banking examiners during the period beginning in 1967 and concluding on or about March 20, 1972, to recover losses sustained allegedly due to either the misfeasance and/or malfeasance of the defendants in the exercise of their statutory duty to supervise and regulate the aforementioned institutions. Jurisdiction of this Court is predicated upon 28 U.S.C. §§ 1331 and 1337, §27 Securities Exchange Act of 1934, 15 U.S.C. §78aa, §22 of the Securities Act of 1933, 15 U.S.C. §17v.

It is plaintiffs' theory, relying on Tcherepnin v. Knight, 389 U. S. 332 (1967) and Tcherepnin v. Franz, Civil No.

64 C 1285 (N.D. Ill., March 12, 1973), that their withdrawable shares are securities within the meaning of the Securities and Exchange Act of 1934, 15 U.S.C. §78a et seq., and, more specifically, within the purview of Section 10(b) and Rule 10(b)-5 promulgated thereunder; and the Commonwealth's acts and/or failure to act constituted certain violations of the aforementioned federal securities laws.

In opposition, the defendant Commonwealth has filed a motion to dismiss pursuant to Rule 12(b)(1) F.R.C.P., 28 U.S.C., challenging jurisdiction here on the ground that the instant suit is precluded by the sovereign immunity clause of the 11th Amendment of the United States Constitution barring suits in federal courts against a non-consenting state by its own citizens. The Commonwealth concludes that, since it has neither expressly or impliedly consented to suit in this tribunal, this Court is without the requisite jurisdiction.

It is the position of the individually-named defendants that the doctrine of sovereign immunity inures to their benefit as agents of the state. Therefore, they cannot be held liable for acts committed within the scope of said employment. This argument raises the secondary issue of whether their duties were discretionary in nature as opposed to ministerial. Lastly, defendants contend that the complaint fails to allege fraud with the degree of particularity required by Rule 9(b) of the Federal Rules of Civil Procedure, 28 U.S.C.

In resolving this jurisdictional issue, the Court is confronted with the threshold question of whether withdrawable capital shares held by depositors in state-chartered savings and loan associations can be termed a "security" within the meaning of the federal securities laws. This Court is bound by the clear mandate of the Supreme Court in Tcherepnin v. Knight, supra, where, in a case factually similar to the one at bar, the Court, in overruling a lower

appellate court decision, held that such shares come within the purview and protection of the Securities Exchange Act of 1934; and, therefore, the district court could properly adjudicate claims brought against a nonconsenting state.

Resolution of this question leads to the more difficult and complex issue of the Commonwealth's claimed right of sovereign immunity protecting it from suit under the particular circumstances of the instant case. It is plaintiff's argument that:

> ". . . the commonwealth has by its acts waived its sovereign immunity, by inducing reliance by the public upon the Commonwealth's supervision and examination of American and failing to protect federally created right."

Contrariwise, the state maintains that her supervision of state-chartered financial institutions operated by private citizens is a strictly governmental function. Consequently, the state's entry into this field of purely intrastate regulation of such institutions does not constitute forfeiture of its constitutionally granted right to be free from suit in a federal forum.

The Court has extensively researched this question and carefully reviewed the parties briefs. Plaintiffs rely primarily upon the district court's decision in Tcherepnin v. Franz, supra, and the questions decided there more closely approximate the legal issues now before the Court. Therefore, the Court feels that a brief comparison of the instant action and Franz would be most beneficial for purposes of this memorandum order.

The Franz case has had a long and complex history beginning on January 17, 1966. Although final judgment was entered on March 12 of this year finding adversely to the state, it is now pending on motion to reconsider. Irrespective of how the district judge decides that motion, it is

conceivable, if not a certainty, that the case will make at least one more trip through the federal appellate system.

From the Court's own analysis of the facts here and those of Franz, the inescapable conclusion is that glaring distinguishable differences exist between the two lawsuits. Although both actions encompass the same basic legal principles, the significant difference between the two proceedings are the roles assumed by the respective states. In Franz, the State of Illinois assumed a proprietary position, whereas in the case at bar the Commonwealth's involvement was governmental in nature.

A brief chronolog of the events leading to the demise of City Savings (hereinafter known as "City") in Franz will sufficiently underscore these fatal differences:

(1) 1959—City's deteriorating position was brought to the state's attention;

(2) 1960 through 1963—The following deficiencies were uncovered and reported to the proper state officials:

(a) lack of control over cash transactons;
(b) distributions to shareholders in excess of net income;
(c) sharply increasing expenses for maintaining a relatively stable amount of deposits;
(d) excess payouts to holders of withdrawable capital shares;
(e) concentration of sixty-nine percent (69%) of all mortgage loans among fifteen (15) borrowers;
(f) improper deferment of excessive advertising costs;
(g) transfer of funds from contingent reserves to pay dividends to holders of withdrawable capital shares.

(3) December 14, 1963—Complete audit revealed capital impairment of many millions of dollars but no corrective action was taken by state officials;

(4) March, 1964—Audit again revealed deteriorating position of City with no affirmative steps taken by the state to protect the depositors;

(5) June 26, 1964—State took custody of City;

(6) March, 1964 through June 26, 1967—The state's delay in proceeding against City resulted in an additional $900,000.00 loss to depositors as these funds were fraudulently diverted for the personal benefit of C. Oran Mensik, majority stock holder and chief executive officer of City;

(7) July 28, 1964—The depositors, acting on false information supplied them by Mensik apparently through collusion with certain state officers, voted in favor of the so-called "Voluntary Liquidation" plan instead of Court-supervised receivership;;

(8) September 7, 1968—Some four years after the state had taken control of City, a federal receiver was appointed.

The "Voluntary Liquidation" plan required that all of City's assets be transferred to three liquidators, two to be appointed by the state and one to be nominated by Mensik.

The evidence revealed that the so-called "Voluntary Liquidation" plan could never have achieved the state objective of revitalizing City for obvious reasons: (1) The plan ignored the economic realities; it was based on an unrealistic and fraudulent evaluation of the financial condition of City. At the time of its institution, City was hopelessly insolvent. (2) Mensik continued to operate City with the voluntary liquidators performing only perfunctory duties. This subterfuge provided Mensik an additional four years in which to further deplete the remaining assets of City. The depositors agreed to the "voluntary" plan, relying on the state's endorsement. Unbeknown to them, the state's support of the program was conditioned on the voluntary liquidators retaining a certain Chicago law firm at a guaranteed fee of one million ($1,000,000.00) dollars. Prior to the federal receivership action, this firm was paid

approximately $500,000.00 in legal fees, further depleting City's meager assets. In spite of all the apparent irregularities, none of its officers or directors or state officials were ever indicted or tried by the state.

From the foregoing, it is obvious that Mensik could not have succesfully perpetrated his fraudulent scheme without the acquiescence of the state. Whether this cooperation was the result of collusion and/or incompetence is unimportant. What was important was that the state's direct involvement in City's affairs resulted in leading its citizens into a false sense of security, when in reality it was on the verge of total insolvency.

The Eleventh Amendment to the United States Constitution provides:

> "The judicial power of the United States shall not be construed to extend to any suit in law or equity commenced or prosecuted against one of the United States by citizens of another state, or by citizens or subjects of any foreign state."

The Amendment has been interpreted to bar suits brought against a state by its own citizens. Hans v. Louisiana, 134 U. S. 1 (1890); Duhne v. New Jersey, 251 U. S. 311 (1920); and Parden v. Terminal R. Co., 377 U. S. 184 (1964). Further, a state may waive this protection and submit to suit in a federal forum. Petty v. Tennessee-Missouri Bridge Comm'n, 359 U. S. 275 (1959) Parden, supra. This waiver may be either implied or expressed, or under certain circumstances may be removed by congressional action. Parden, supra.

It is the plaintiff's position that the Commonwealth, by entering an area subject to concurrent federal regulation, has explicitly waived its sovereignty. The Court does not agree. To hold otherwise would, in the words of Justice Bradley speaking to this issue in Hans v. Louisiana,

supra, "strain the Constitution and the law to a construction never imagined or dreamed of."

The plaintiffs and defendants, to further support their respective positions, rely primarily on Parden, supra, and Employees of Dept. of Public Health & Welfare v. Missouri, 93 S. Ct. 1614 (1973). Therefore, the Court believes a brief discussion of these two decisions would be appropriate.

Parden involved a state-owned railroad operating for profit in interstate commerce and the suability of the State of Alabama by employees seeking overtime compensation under the Federal Employers' Liability Act, 45 U.S.C. §51 (F.E.L.A.). The Court found that Congress, through the Commerce Clause, was empowered to regulate interstate railroad carriers, whether they be private or public owned. Therefore, the application of the Act and suits thereunder were not precluded by the Eleventh Amendment.

Defendants maintain, and this Court agrees, that the far-reaching scope of Parden has now been narrowed by the recent decision in Employees, supra. The Supreme Court, by denying a direct federal remedy in Employees, distinguished Parden by finding that the activities there were "proprietary" in nature whereas in Employees, the non-profit operations by the state were considered "governmental in character."

Employees involved the application of §16(b) of the Fair Labor Standards Act (FLSA) to employees working in state-operated hospitals and schools. In addition to the non-proprietary nature of the state's activities, the Court considered the relationship these activities had on interstate commerce. The Court reasoned that should it be found that the state's operation of these facilities so greatly related to interstate commerce as to affect national policy, then the state's sovereignty could be lifted by Congress. However, the Court presumed that "a responsible Congress" would not take such action "silently."

Since a review of the legislative history of FLSA did not disclose a congressional purpose to deprive a state of its constitutional immunity to suit in a federal forum, the Court concluded that the federal courts were without the requisite jurisdiction to adjudicate claims brought thereunder.

Important similarities are present in the instant action as existed in Employees. Here, as in Employees, the Court is confronted with determining the suability of a state for acts committed in the performance of a strictly governmental function—regulation of securities. The Commonwealth, prior to seizure of the two institutions on April 3, 1972, did not assume a direct managerial position in the affairs of American or Prudential. The state's involvement was limited solely to her statutory duty to supervise and regulate.

Further, the Court does not find that the Commonwealth, in choosing to provide this needed public service, voluntarily consented to have claims brought against her as a result of such activities adjudicated in a federal forum. As Mr. Justice Marshall stated in his concurring opinion in Employees, supra:

> "To suggest that the state had the choice of either ceasing operation of these vital public services or 'consenting' to federal suit suffices, I believe, to demonstrate that the state had no true choice at all and thereby that the state did not voluntarily consent to the exercise of federal jurisdiction in this case."

In view of the foregoing, the amenability of the Commonwealth to suit in this forum turns on whether Congress, in creating this cause of action, intended to deprive the states of their sovereignty. A review of the Acts failed to reveal an expressed desire by the federal legislature to infringe on the doctrine of sovereign immunity. As stated

in Employees, had Congress so intended, it would not be presumed to have acted "silently."

It is the conclusion of this Court that the Commonwealth of Kentucky is not amenable to suit in this Court for alleged violations of the federal securities laws.

The motions to dismiss of E. G. Adams, Thomas G. Florence and Robert C. Musselman will be overruled. The Court having reviewed the Complaint finds the requisite jurisdiction and believes it sets out sufficient allegations, if proven, to state a cause of action.

It is felt that a more dependable method of testing the factual basis of the claim would be for the parties to proceed with the available pre-trial discovery procedures and thereafter move for summary judgment should the defendants at that time feel the claim is insufficient as a matter of law.

Wherefore, It Is Ordered And Adjudged that:

(1) The motion to dismiss the complaint by the Commonwealth of Kentucky is sustained;

(2) The motion to dismiss of Robert C. Musselman and Thomas G. Florence is overruled; and

(3) The motion to dismiss of E. G. Adams is overruled.

This 24 day of August, 1973.

(s) Rhodes Bratcher
United States District Judge

APPENDIX E

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF KENTUCKY
AT LOUISVILLE

No. 7635-B

ARTHUR W. BROWN, Receiver - - - *Plaintiff*

v.

COMMONWEALTH OF KENTUCKY, ET AL. - *Defendants*

ORDER—Entered Aug. 29, 1973

This action is before the Court on motions to dismiss of the defendants, Commonwealth of Kentucky; E. G. Adams, former Commissioner of Banking and Securities; Robert L. Musselman and Thomas G. Florence, former state banking examiners; and Perry R. Miller, acting Commissioner of Banking and Securities for the Commonwealth of Kentucky. The suit was brought to recover damages sustained by depositors in the Prudential Building and Loan Association allegedly caused by the "acts or omissions" of the defendants in the performance of their statutory duty to supervise said institution. Jurisdiction is predicated on 28 U.S.C. §1331 and 1337, §27 Securities Exchange Act of 1934, 15 U.S.C. §78aa, §22 of the Securities Exchange Act of 1933, 15 U.S.C. §17v.

Plaintiff contends, and this Court, following the mandate in Tcherepnin v. Knight, 389 U. S. 332 (1967), must agree, that capital shares held by depositors in building and loan

associations are securities within the meaning of the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq, and the regulations promulgated thereunder. Combining this decision and Tcherepnin v. Franz, Civil No. 64 C 1285 (N.D. Ill., March 12, 1973), the plaintiff concludes that suits brought against a non-consenting state for either misfeasance and/or malfeasance in the regulation of such activities subjects said sovereignty to the jurisdiction of the federal courts.

This Court recently entered a Memorandum and Order holding that the federal district court was without jurisdiction to adjudicate claims brought against a non-consenting state under the federal securities laws. Barr v. Commonwealth of Kentucky, et al., Civil No. 7637-B (August 24th, 1973). It was therein adjudged that suits of this nature are barred by the Eleventh Amendment of the United States Constitution. In reaching this conclusion, this Court reasoned that the Commonwealth, by entering an area subject to concurrent federal regulation, neither expressly nor impliedly consented to the adjudication of claims brought against it in this forum. Further, a review of the relevant statutes did not disclose any congressional purpose to deprive the states of their constitutional immunity to suit in the federal courts.

The decision in Barr, ibid., requires dismissal of the complaint against the Commonwealth in this action. Further, Perry R. Miller, Acting Commissioner of Banking and Securities, must also be dismissed.

Since the instant proceeding arises from the same factual situation requiring adjudication of the same legal questions as in Barr, the reasons cited by this Court there are applicable here; therefore, a lengthy memorandum of reasons and authorities will not be made.

Wherefore, It Is Ordered And Adjudged that:

(1) Commonwealth of Kentucky's motion to dismiss is sustained;

(2) Perry R. Miller's motion to dismiss is sustained;

(3) Motions to dismiss of Robert C. Musselman and Thomas G. Florence are overruled; and

(4) Motion to dismiss of E. G. Adams is overruled.

This 28th day of August, 1973.

(s) Rhodes Bratcher
United States District Judge

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF KENTUCKY
AT LOUISVILLE

No. 7635-B

ARTHUR W. BROWN, Receiver - - - *Plaintiff*

v.

COMMONWEALTH OF KENTUCKY, ET AL. - *Defendants*

AFFIDAVIT OF COUNSEL IN SUPPORT OF MOTION TO RECONSIDER—Filed Sept. 25, 1972

Comes now, the Affiant, James N. Williams, Jr., and states that he is counsel of record on behalf of Plaintiff, Arthur W. Brown, Receiver in the above styled action. In further support of the Motion to Reconsider filed herein on or about September 8, 1973, the undersigned states that if this case is allowed to proceed, Plaintiff expects to prove a great number of facts which are in conflict with the facts assumed by opinion and order dated August 29, 1973. Attached hereto are true and accurate copies of articles which have appeared in the Louisville Courier Journal and Times on April 23, 1972 and on April 27, 1973. These newspaper articles clearly show facts, going even beyond the facts stated in the undersigned's Motion to Reconsider, which are as reprehensible as those in the City Savings case, and if this case is allowed to proceed, the undersigned counsel expects to be able to prove these facts.

The undersigned draws the Court's attention, especially to Page 2 of the article of April 23, 1972. On October 2,

1961, the Commissioner of Banking & Securities wrote to Prudential's directors stating:

> "I am taking charge of the association on the ground that you are operating in an unsafe manner."

Hence, Prudential's situation is even worse than the one at City Savings, and the factual distinctions in the order of August 29, 1973, and the order of August 24, 1973, in the related class action are in error and said orders should be set aside.

(s) James N. Williams, Jr.

EXHIBIT A

DOCUMENTS SHOW PRUDENTIAL OPERATIONS DREW RECURRING CRITICISM FROM OFFICIALS

April 23, 1972

By Livingston Taylor

Courier-Journal Staff Writer

Frankfort, Ky.—Prudential Building & Loan Association, Louisville, closed and placed in receivership April 3, has periodically come under severe criticism from the state Banking Department almost from the association's beginning in 1953.

"Deplorable condition," "violation of nearly every section of the building and loan law," "reserves alarmingly low," and "very perilous condition" are some of the comments made over the years about Prudential by state Banking Department officials.

In 1961 a banking commissioner actually took charge of Prudential "on the ground that you (Prudential) are operating in an unsafe manner." The custodianship, which apparently was not publicized, seems to have lasted about two months.

There are some gaps in the records from which the following history of the Banking Department-Prudential relationship was gleaned. The source of the information declined to be identified publicly. However, the authenticity of the records and correspondence involving the state Banking Department and Prudential over the years has been verified to this reporter's satisfaction.

The records indicate that Robert L. Musselman of Louisville, fired Thursday as a state banking examiner, made both favorable and unfavorable comments in his examination reports on Prudential.

Musselman was examining Prudential during the years in which Prudential paid about $294,000 to his wife's advertising service. In several of his reports, Musselman apparently criticized advertising and promotional costs as too high.

Musselman was the state examiner assigned to take charge of Prudential during most of the period in 1961 when then Banking Commissioner H. A. Rogers took over control of its affairs.

The records show that the department repeatedly criticized Prudential's practice of offering costly merchandise gifts as a way of attracting new deposits, but Prudential's management continued the practice.

There also was criticism as early as 1955 of Prudential loans to businesses controlled by the family of H. M. Dunn Sr., president of Prudential.

Prudential had made almost $19 million in loans—more than 60 percent of its total loans—to Dunn family-controlled enterprises by the time the present state banking commissioner, Lenvil Hall, in office since January, moved against the firm April 3.

Here are excerpts from the records, listed chronologically:

Dec. 1, 1954—Letter from Banking Commissioner H. H. Carter to Prudential's board of directors: "Report discloses a generally satisfactory condition . . . however, although your association has been in operation only a short time, many deficiencies are in evidence."

Aug. 27, 1955—Internal letter from examiner Thomas A. Dedman to Deputy Banking Commissioner R. E. Glenn: "I was unable to balance any of the accounts . . . Mr. Dunn does not even know the amount of the loans, or which loans are supposedly owned by the association. Three of the loans are signed by three companies of which Mr. Dunn signs, as president . . ."

Aug. 30, 1955—Letter from Glenn to H. M. Dunn Sr., Prudential president: The letter summarized Dedman's report and concluded, "We will not tolerate conditions of this kind in any institution. Please advise us immediately upon obtaining an auditor to take care of this situation."

Sept. 9, 1955—Reply from Dunn to Glenn, advising that an accountant had been retained and would bring records up-to-date.

Oct. 27, 1955—Letter from Glenn to Prudential's board of directors, accompanying annual examination report: "Generally satisfactory condition . . . We anticipate that correction will be made of the matters brought to your attention . . ."

March 9, 1956—Internal letter from examiner Freeman Gilbert to Commissioner S. Albert Phillips concerning Prudential examination: "I believe the best interests of the depositors . . . and the public generally will be served . . . by allowing the people responsible for the conduct of its (Prudential's) affairs another opportunity to correct the legal and technical defects and otherwise straighten out the books and records . . . I am somewhat hopeful that they will try to correct this deplorable condition but the fact (is) that they never have since they started in September 1953 after repeated warnings from examiners. If things do not look all right in 60 days, then some other drastic action may become necessary."

March 26, 1956—Letter from Commissioner Phillips to Prudential's directors, accompanying annual examination report: "This report reflects a generally unfavorable condition . . . one that must be corrected if you are to continue operations. The examiner in his comments calls attention to the violation of nearly every section of the building and loan law . . . or the charter surrendered." The letter called for monthly progress reports until further notice.

March 29, 1956—Reply from Dunn to Phillips: ". . . Correction to be made."

May 3, 1956—Letter from examiner Gilbert to Commissioner Phillips, listing corrective measures and concluding, ". . . In fact of major compliance with all deficiencies, I recommend that this association continue to make monthly reports until everything is cleared satisfactorily."

Sept. 30, 1957—Letter from Commissioner Phillips to Prudential's directors, accompanying annual report of examination: "Our examiner reports several violations of the statute . . ." A conference with a majority of the directors was requested.

Oct. 4, 1957—Reply from Dunn to Phillips: "We feel that all the matters mentioned . . . can easily be explained and corrected." Letter agreed to a conference.

Feb. 22, 1958—Internal letter from examiner Dedman to Commissioner Phillips, reporting Prudential's loans to two Dunn residential developments as "way out of line."

Nov. 6, 1958—Letter from Federal National Mortgage Association to banking commissioner, asking for figures to determine if Prudential should be approved as a seller-servicer of FNMA-insured and Veterans Administration—guaranteed mortgages.

Nov. 10, 1958—Reply from Commissioner Earle B. Combs to FNMA: "It is my considered opinion that this application should be rejected since their methods of operation are not entirely in accord with what we consider a bona fide building and loan association."

March 11, 1959—Letter from Dunn Sr., to Banking Department in response to apparent criticism of merchandise premiums given to attract new accounts: ". . . Realizing that we have been guilty of some abuses by giving too large and too expensive premiums, we would like . . . to limit our premiums to not more than a $100 contingent deposit. We hope as soon as our position is completely stabilized to eliminate entirely the promotion plan."

Nov. 24, 1959—Letter from Commissioner Combs to Prudential's directors, with annual report: "This report reflects a sound asset condition . . . and a favorable trend."

Oct. 25, 1960—Letter from Commissioner H. A. Rogers to Prudential's directors: "Examiner Dedman's report of examination . . . causes us to be alarmed over some of the developments in your association . . . The policy of lending at a discount to obtain premiums is indicative of the extremely liberal position you are taking."

Oct. 2, 1961—Letter from Commissioner Rogers to Prudential's directors: "I am taking charge of the association on the ground that you are operating in an unsafe manner. I am delegating examiner R. E. Soper as the representative of this office and you will follow his instructions until further notice."

Oct. 5, 1961—Letter from Deputy Commissioner James McNeely to examiner Robert L. Musselman: "You are hereby authorized to relieve Mr. R. E. Soper and take charge of the Prudential Building and Loan Association . . ."

Dec. 22, 1961—Letter from Commissioner Rogers to Prudential's directors, accompanying report of examination: "The writer . . . has offered specific recommendations with which you are familiar."

Dec. 27, 1961—Letter from attorney Joseph Stopher on behalf of Prudential to Commissioner Rogers: "The association was, of course, greatly handicapped during the period from October 3 to November 24 when no new business was taken on pursuant to your direction. However, the association has made a remarkable record during the past few weeks . . ."

Feb. 16, 1962—"Progress Report" from Dunn Sr. to Commissioner Rogers as requested by examiner Musselman: ". . . The advertising is running slightly higher . . . than our budget intended . . . We intend to stay within that budget . . . We feel that this situation will shortly be such that it will be of no concern or worry whatsoever."

Sept. 11, 1962—Letter from Commissioner Rogers to Prudential's directors with annual report of examination: ". . . Accumulated reserves have not kept pace with the rapid growth of the association which is resulting in a very low margin of protection for shareholders . . . The heavy amount of loans to officers, directors and employes continues to be a matter of severe criticism. Our insistence on removal of these loans has met with little results . . . This is an area in which immediate improvement should be effected."

June 11, 1963—Letter from Commissioner Rogers to Prudential's directors accompanying annual report: "The ratio of reserves to total volume of business is alarmingly low . . . It is the recommendation of this office that more conservative policies be adopted, that loan accounts be allowed to season and that promotional activities be minimized."

June 11, 1964—Letter from Commissioner Rogers to Prudential's directors: "The examination of your associa-

tion . . . reflects a very perilous condition . . . Notwithstanding the constructive advice which has been given from time to time, you have continued to expand the loan account, increase your liabilities through heavy and expensive advertising, and, in general, operate in an unsafe and unsound manner . . . We believe the situation is so grave that the directors of the association be required to appear at this office for a hearing on June 25 . . ."

July 1, 1964—Reply from H. M. Dunn Jr., Prudential secretary, to Rogers' June 11 letter: ". . . We are ever aware that our reserves are not as strong as we would like to have them, however, we feel that we are steadily increasing these . . . Our problems with foreclosures are comparative to the problems experienced by all other building and loan assoications . . . Prudential is now climbing in relation to reserves and undivided profits . . ."

April 22, 1965—Letter from Commissioner G. D. Beach to Prudential's directors, accompanying examination report by examiners Musselman and Thomas G. Florence: "We refer you to the examiners' comments and recommendations . . . and request . . . prompt attention."

May 18, 1966—Letter from Commissioner Beach to Prudential's directors, accompanying examination report by Musselman and Florence: "Closer supervision by your board is needed in a number of areas . . . Advertising expenses have doubled in the past year . . . It represents the largest single item in your increased expenses." The letter also indicated the report mentioned reserves, delinquent loans and low fidelity bond coverage.

May 4, 1967—Letter from Deputy Commissioner Joe R. Johnson Jr. to Prudential's directors, accompanying examination report by Musselman and Florence: "The total of delinquent loans . . . would indicate the need to continue to be aggressive in following up these accounts. However, the examiners' comments on Page 7 note an improvement in the overall operation . . . you should carefully evaluate the effect of the increased (interest) rate . . . and the premium advertising."

July 5, 1968—Letter from Deputy Commissioner Johnson to Prudential's directors, accompanying examination report by Musselman "and associate": "The examiners note that improvement in servicing the loan account that was in evidence at the previous examination is continuing . . . The major problem is retaining sufficient earnings in reserve accounts to match your growth . . . Reserves are still low."

June 11, 1969—Letter from Commissioner E. G. Adams to Prudential's directors, accompanying examination report by Musselman and associate: "Your attention is directed to the examiner's comments on Page 6 and we strongly urge you to adhere to the examiner's recommendations relative to the strengthening of reserves and liquid condition."

June 30, 1970—Letter from Banking Department executive officer E. Frederick Zopp to Prudential's directors, accompanying examination report by Musselman and associate: "We are pleased to note that your association has done well to hold its own since the last examination. The examiners' comments continue to stress your excessive expenditures for advertising and promotion. Inasmuch as your expanding asset condition is no doubt the result of your aggressive advertising, your efforts to maintain present reserve levels are commendable. Nevertheless, your reserve strength has increased only imperceptibly."

June 19, 1971—Internal letter from Musselman to Commissioner Adams headed: "Re: Additional Data—Prudential Building & Loan."

"Mr. H. M. Dunn Jr. . . . is arranging for a certified public accounting firm to audit the association's books and records as soon as possible . . ."

Musselman's letter included three paragraphs on Prudential's handling of returned checks and "change" checks given to customers who make a deposit with a check larger than the deposit.

Musselman then related that Dunn Jr. bought about 200 acres on River Road in Jefferson County for $128,000; obtained a "loan commitment" of $500,000 from Prudential for development of the property, of which $177,127 actually was loaned, and then sold the land to Louisville Water Co. in 1967 for $750,000, realizing a net profit of $448,372.

Under "miscellaneous," Musselman said certain "technical exceptions" concerning the appraised value of a Dunn Jr. development project "were corrected during visit."

"In my opinion, the outside audit is the important factor at this time. I trust this is the desired information," Musselman concluded.

June 23, 1971—Letter from Commissioner Adams to Prudential's directors, accompanying examination report by Musselman and associate: "Special emphasis should be placed upon the reserve position which is considered low and every effort should be made to remedy this position to the place where you will have at least 5 per cent in reserves. To accomplish a strengthening of the reserve position, it will be necessary that you cut down on operating expenses, with advertising and promotional (costs) contributing greatly to this expense.

"In order that you might accomplish some of the improved position of reserves and liquidity, we ask that you submit a report to this office by July 15 of your plans to remedy these two situations."

July 13, 1971—Reply by Dunn Sr. to Adams: "We had, prior to your letter of June 23, 1971, taken steps to reduce our promotional and advertising expenses. Our advertising agency, T. Jefferson Wright and Associates, were called in during the first week of June, and advised to immediately

cut all advertising expenses by 33 per cent. This cut was to include radio, television, direct mail and newspapers, and I am sure, if you have been noticing the Louisville Times and the Courier-Journal, you will notice that Prudential's space is one-fourth to one-third of what it has been during the same period of previous years. This, we feel, will help our reserve position to the extent that the money normally spent on advertising will be directed towards the reserves."

"We are also at the present time reviewing office personnel to see if there is any way possible of eliminating any of these salaries.

"We know that your office is ever aware of the problems that face the savings and loan associations throughout the state, with the ones in Louisville being in a more difficult situation, with the competition from the local banks and the federal savings and loans . . . However, we do not intend to let these things block our objectives, among which are . . . strengthening the reserve position . . . Our cash position is good, but even that, we intend to improve.

"We feel, Mr. Adams, that the elimination of the percentage of advertising as stated above, which in turn will have the relative effect on the promotional gifts, will indeed head us in the direction that you have suggested, and your examiners have recommended.

"Trusting that the above complies with your letter of June 23, 1971, we remain, respectfully yours, H. M. Dunn, president."

EXHIBIT B

DUNN JR. REFLECTS: 'I'M NOT A CON MAN'

April 27, 1973

By Phil Norman
Courier-Journal Business Writer

H. M. (Skip) Dunn Jr., who once had offices large enough to widen the eyes of other executives, sat in a dingy little room near the main entrance of the Kentucky State Reformatory at La Grange.

He was wearing street clothes and explained that prisoners are "permitted to wear khaki clothes or blue." His khaki jacket and pants were his own, he said, but "I wouldn't claim ownership of the (white) shirt."

A young official of the reformatory sat quietly near the door, listening to Dunn's answers to a reporter's questions.

Dunn, who lives in a dormitory wing with about 40 other inmates and does clerical work in a prison office, noted that he had been escorted through three iron gates to get to the interview.

Two more gates stood between him and the Oldham County countryside where he used to have some of his real-estate developments and farming operations.

He observed, in the course of the interview, that he once owned a dairy farm adjacent to the prison and sold it for a profit of about $150,000.

Dunn and his father, H. M. Dunn Sr., have been sentenced to 15-year terms in the aftermath of the financial scandal of the Prudential and American building and loan associations and related Dunn companies.

They have been at the reformatory a little more than two months. The elder Dunn, who is 74 years old and assigned to a geriatrics ward, wasn't interviewed.

But the younger Dunn, aggressive, sharp-eyed and youthful looking at 46, was willing to talk at length.

He is full of praise for the way the reformatory is run, saying that it has "a terrific bunch of correction and treatment people." They are extremely fair, not a bunch of custodians."

But he expresses bitterness, mostly about the newspapers that he accuses of nurturing public resentment of him and his father, and the court-appointed receivers who have taken over their shattered financial network.

Angered by an editorial opposing "shock probation" for him and his father, he says he thinks "that The Courier-Journal (editorial) staff and the owner are the cruelest people who ever lived."

"If you write that I'm not pounding rocks, it's going to hurt me," he says with a hint of defensive sarcasm.

In the background of everything he said were the prison and the spectre of at least 18,000 Prudential and American depositors who stand to lose millions of dollars of their savings in the two Louisville associations.

Against that background, Dunn comes off as a man of mental agility, expressing attitudes that often seem at least vaguely contradictory.

He remains active, he says, working 8 to 12 hours a day in the job-classification section of a prison office.

In his spare time, he adds, he is "writing a hell of a novel about life here." He says that he has just finished the part about the "fish tank," as the prison's reception area is called.

However, he hasn't taken much part in recreation or vocational programs.

"I've never played baseball. They don't have a fishing boat here. I can't go fishing for tuna. . . . They don't have an airport, so I can't further my flying."

His mildest charge against the receivers is that they are inflating the Prudential and American losses by failing to get high enough prices for Dunn properties.

"I don't think I've done a goddamned thing," he declared at one point. "I think me being here is the goddamnest farce that ever existed. If anyone belongs here, I think it's the receivers that followed me."

Yet, replying to questions later in the interview, he accepted the primary blame for the depositors' plight and said that he plans to make restitution.

Asked how he could have brought himself to solicit deposits for an insolvent institution, he answered that "that's the only thing that bothers me. . . . It's a question that can't be answered."

When he gets out of prison, he says, he intends to go to Florida to resume his career as builder and real-estate developer. He says he will "make the money back and repay the depositors."

"I believe a person that's half sharp may just get this one shot in a million," he says in reference to his chances for striking it rich enough to make up for the huge savings-and-loan deficit.

Dunn was secretary-treasurer of Prudential, formally headed by his father, who founded it some 20 years ago. He was president of American, a smaller association taken over by the Dunns in 1970.

He contends that Prudential had been an unsound institution for years and that his sometimes illegal financial dealings were aimed at keeping it going and perhaps making enough money to put it in the black.

Denying that any money was embezzled, he says that millions of dollars in fraudulent loans to Dunn companies actually were used to pay dividends on depositor's savings. Legally, such dividends must come from earnings.

Even while admitting his own guilt, he attempts to shift some of the responsibility to the state. More than 10 years ago, he inisists, he asked a state banking official—now deceased—to close Prudential. He says that the state then was unwilling to take such drastic action.

"In effect," he says, "I was told to break the law."

He could have asked subsequent state administrations to stop the Prudential fraud, Dunn acknowledges, but he says he couldn't overcome his fear of the consequences.

His illegal acts were "violations of necessity," Dunn says. "The first one was like a little white lie. Then you realize what you're doing. You can't stop, because you're trapped.

While he has developed "good, fast footwork," he says, "I'm not a con man. I don't believe I am. I never have been that."

Two criticisms seem particularly irritating to Dunn: that he was addicted to high finances and high living and that he made bad real-estate deals.

"I wasn't impressed with high living," he says. "I never paid more than $150 for a suit. I only drove one car." Other cars listed in his name were for employes, he says.

Before he moved into an impressive Colonial style house on his farm near Simpsonville, Dunn adds, he lived in "what I considered a beautiful, large, three-bedroom, two bathroom house right next to a smelly mare barn."

As to the other criticism, he declares that "every piece of property sold by me showed a good markup."

He contends that total losses might have been held to $3 million or $4 million if the associations had been placed under a "monitor or conservator" instead of being dismantled by receivers.

Prudential and American were closed and placed in receivership on April 3, 1972, at the request of the state Department of Banking and Securities. Reports from receiv-

ership officials indicate that Prudential's losses might be more than $20 million but that the American deficit is much smaller.

The Dunns pleaded guilty in Jefferson Circuit Court to charges of approving fraudulent loans at Prudential. They pleaded no contest to income-tax evasion charges in U. S. District Court.

There has been some uncertainty as to when the Dunns will become eligible for parole. Reformatory officials said that the two men could have a parole hearing in March 1974—in the 13th month of their imprisonment.

In the meantime, the Dunns have applied for probation under a new state law allowing some prisoners to be released after the initial "shock" of a prison sentence.

A hearing on the request is set for May 11, according to an attorney for the Dunns. If it were granted, the probation would apply only to the 10-year state court sentences, not to the concurrent 15-year federal sentences imposed on the Dunns.

"I never had any hope of shock probation," the younger Dunn said in the interview. He said, however, that "I don't think there is one chance in a million I would ever make this mistake again or anything akin to it."

He added that he thinks his father has been "punished and penalized with the shock of being here. He probably has had a sufficient amount of punishment for what little he did."

Dunn says that he sees his father regularly in the daily course of prison life.

"You might say he is adjusting," Dunn observes, "but if you write that, they'll say he loves it and let's just keep him there."

He and his father are doing the "easy time," he said, explaining that "if you do your job properly and stay out of trouble, you're going to be okay."

He added that "the hardest thing was the loss of my family." Dunn's wife lives in Florida. His fifth child was born this month.

The reformatory has radio, television and library facilities, Dunn says, and he thinks that his clerical job should earn him a room of his own "after a period of time."

Dunn started the interview cautiously. Before it was over, however, he was talking with some of the brashness that seems to be part of his nature.

"I was on a ship you could put in the front part of this building," he said. "This is a kindergarten compared with the service."

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF KENTUCKY
AT LOUISVILLE

No. 7635-B

ARTHUR W. BROWN, Receiver - - - *Plaintiff*

v.

COMMONWEALTH OF KENTUCKY, ET AL. - *Defendants*

MEMORANDUM AND ORDER—Entered Dec. 12, 1973

This action comes before the Court on motion of the plaintiff to reconsider and to set aside this Court's Order entered on August 29, 1973, dismissing the Commonwealth of Kentucky as a party defendent in the above-styled action.

The movant contends this Court erred in distinguishing and failing to rely upon Tcherepnin v. Franz, Civil No. 64C1285 (N.D. Ill., March 12, 1973), in determining the suability of the Commonwealth in the instant controversy. It is further argued that the Court misconstrued Parden v. Terminal R. Co., 377 U. S. 184 (1964) and Employees of Dept. of Public Health & Welfare v. Missouri, 411 U. S. 279 (1973), in holding Kentucky's activities in the performance of its statutory duty to regulate state-chartered savings and loan associations to be "governmental in character", thereby not constituting a waiver of its sovereign immunity to suit in a federal forum.

In opposition, the defendant Commonwealth has tendered a recent order entered October 10, 1973, in Franz, which provided in its pertinent parts:

> "The instant proceedings against the State of Illinois presented unique circumstances that are sui generis and that the Court's Memorandum of March 12, 1973, was not intended to and does not provide a precedent for actions against a state in its sovereign capacity, save as otherwise provided by law."

The Court, having once again carefully reviewed the pleadings, exhibits, memorandums of authorities, the above-quoted order, and being otherwise sufficiently advised, finds plaintiff's legal theories to be unpersuasive and is more convinced of the soundness of its earlier decision.

It is the firm belief of this Court that the Commonwealth, in voluntarily choosing to regulate the institutions in question, neither expressly nor impliedly waived its immunity to suit in this forum as guaranteed by the Eleventh Amendment to the Constitution of the United States. Kentucky's entry into this area of concurrent federal regulation was strictly governmental in nature and at no time did the state in the performance of its duty expand its activities to the extent necessary to find such supervision to be termed proprietary in character, a role obviously assumed by the State of Illinois in Franz, supra. It is apparent, as so aptly argued by plaintiff, that certain factual similarities are present in both the case at bar and the Franz case, supra. However, the previous order discussed at length the many glaring distinguishable features between these two actions which this Court feels greatly diminishes, if not destroys, whatever supportive value provided by the Illinois decision for plaintiff's position here.

It is believed the previous Order sufficiently delineated the reasons for the dismissal of the Commonwealth as a

party from present controversy. Therefore, a lengthy discussion at this time would be inappropriate and would serve no useful purpose.

Wherefore, It is Ordered and Adjudged that plaintiff's motion to vacate and set aside this Court's Order of August 29, 1973, is hereby Overruled.

This 12th day of December, 1973.

(s) Rhodes Bratcher
United States District Judge

ORDER—Entered Jan. 7, 1974

Upon the Motion of the Plaintiff, it is hereby ordered that the paragraph (1), page 3 of the Order entered herein on August 29, 1973 be and hereby is amended to read as follows:

(1) "Commonwealth of Kentucky's Motion to Dismiss is sustained. There is no just reason for delay, and, insofar as this ruling on the Commonwealth's Motion is concerned, this is a Final Order."

(s) Rhodes Bratcher
Judge
Date: 1-7-74

Supreme Court, U. S.
FILED
JUL 19 1975
MICHAEL RODAK, JR., CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1974

No. 74-1627

ARTHUR W. BROWN, Receiver ..... PETITIONER

VS:

COMMONWEALTH OF KENTUCKY ..... RESPONDENT

ON PETITION FOR WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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MAY IT PLEASE THE COURT:

OPINION BELOW

The opinion below from the United States Court of Appeals for the Sixth Circuit, dated April 2, 1975, which is reported at 513 F.2d 333, appears in Petitioner's Petiton, Appendix B. The opinions of the United States Dis-

trict Court for the Western District of Kentucky, which are not reported, appear in Petitioner's Petition, Appendix E.

JURISDICTION

Petitioner invokes the jurisdiction of this Court under 28 U.S.C. 1254(1), the proper provision for a decision of the United States Court of Appeals.

QUESTION PRESENTED

WHETHER THE FEDERAL COURTS HAVE THE REQUISITE JURISDICTION TO ADJUDICATE AN ACTION AGAINST THE COMMONWEALTH OF KENTUCKY BROUGHT BY ONE OF ITS CITIZENS UNDER THE FEDERAL SECURITIES ACTS, WHERE THE COMMONWEALTH HAS NEITHER CONSENTED TO BE SUED NOR WAIVED ITS ELEVENTH AMENDMENT IMMUNITY FROM SUIT IN FEDERAL COURT.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Constitutional and Statutory provisions involved are adequately set forth in the Petition.

STATEMENT

This action is before this Court to review the Opinion of the United States Court of Appeals for the Sixth Circuit which affirmed the opinion of the United States District Court for the Western District of Kentucky.

The District Court sustained the Commonwealth's Motion to Dismiss petitioner's complaint against it on the

jurisdictional basis that the Commonwealth had neither consented to be sued nor waived its Eleventh Amendment immunity from suit in federal court.

The United States District Court for the Western District of Kentucky, Honorable Rhodes Bratcher, Judge, in its Opinion in this case, concluded that the Commonwealth was not amenable to suit in federal court for alleged violations of federal securities law because: (1) the Commonwealth, by entering an area subject to concurrent federal regulation, neither expressly nor impliedly consented to the adjudication of claims against it nor waived its Eleventh Amendment immunity in federal court and (2) a review of the relevant federal securities statutes did not reveal an expressed desire by Congress to deprive the states of their constitutional immunity to suit in federal court (Appendix D of Petition).

The Sixth Circuit affirmed the judgment of the District Court (Appendix B of Petition).

ARGUMENT

THE FEDERAL COURTS DO NOT HAVE THE REQUISITE JURISDICTION TO ADJUDICATE AN ACTION AGAINST THE COMMONWEALTH OF KENTUCKY BROUGHT BY ONE OF ITS CITIZENS UNDER THE FEDERAL SECURITIES ACTS, WHERE THE COMMONWEALTH HAS NEITHER CONSENTED TO BE SUED NOR WAIVED ITS ELEVENTH AMENDMENT IMMUNITY FROM SUIT IN FEDERAL COURT.

The Eleventh Amendment to the United States Constitution precludes the exercise of federal court jurisdiction in the case at bar.

The Eleventh Amendment reads:

> "The Judicial Power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another state, or by Citizens or Subjects of any Foreign State."

Although this amendment is not literally applicable since most or all of the plaintiffs are residents of the Commonwealth, this Court has consistently held that an unconsenting State is immune from suits brought in federal courts by her own citizens as well as by citizens of another State. *Hans* v. *Louisiana,* 134 U.S. 1, 33 L.Ed. 842, 10 S.Ct. 504 (1890); *Parden* v. *Terminal R. Co.,* 377 U.S. 184, 12 L.Ed2d 233, 84 S.Ct. 1207 (1964); *Employees* v. *Department of Public Health and Welfare,* 411 U.S. 279, 36 L.Ed.2d 251, 93 S.Ct. 1614 (1973); and *Edelman* v. *Jordan,* 415 U.S. 651, 39 L.Ed2d 662, 94 S. Ct. 1347 (1974).

It is well established that a state may waive its Eleventh Amendment right and submit to the jurisdiction of the federal courts. *Petty* v. *Tennessee-Missouri Bridge Comm.,* 359 U.S. 275, 3 L.Ed.2d 804, 79 S.Ct. 785 (1959); *Parden,* supra; *Employees,* supra.

However, the Commonwealth of Kentucky has not waived its Eleventh Amendment immunity by consenting to being sued in federal court. Furthermore, immunity from suit is a sovereign right of the Commonwealth and such is provided for by Section 231 of the Kentucky Constitution which reads:

> "The general assembly may, by law, direct in what manner and in what courts suits may be brought against the Commonwealth."

In *Taylor* v. *Westerfield,* Ky., 26 S.W.2d 557 (1930), the Kentucky Court of Appeals explained the purpose of Section 231:

> "The reason for exempting a municipality or sovereign from damages for injuries inflicted in the performance of its governmental functions is one of public policy to protect public funds and public property. Taxes are raised for certain specific governmental purposes, and, if they could be diverted to the payment of damage claims, the more important work of government, which every municipality or sovereign must perform, regardless of its other relations, would be seriously impaired, if not totally destroyed. The reason for the exemption is sound and unobjectionable."

Section 231 places a very specific limitation on the power of the General Assembly to waive the Commonwealth's immunity. Only the General Assembly has the power to waive this immunity and such cannot be waived indirectly or by implication.

As the Kentucky Court of Appeals in *Foley Construction Company* v. *Ward, Ky.,* 375 S.W.2d 392, 396 (1963), stated:

> ". . . To reiterate, the constitutional section in question has always been every explicit. The word 'may' in Section 231 indicates that suits against the Commonwealth may be brought as a matter of legislative grace. *Commonwealth* v. *Chevis,* 4 Ky. Law

Rep. 892. *Only by authority "of an enactment of the Legislature may such suit* be brought, and *then the manner of bringing a suit and the court in which it may be brought must be directed. . . ."* (Emphasis added.)

Thus, the Commonwealth has not consented to be sued or waived its immunity from suit in federal court.

In addition to the fact that the Commonwealth has not consented to this type suit, there is no indication that Congress has expressed an intent that a state should be amenable to suit in federal court by entering into an area subject to concurrent federal regulation, i.e., the regulation and supervision of financial institutions.

Nowhere in the Securities Act of 1933 nor in the Securities Exchange Act of 1934 can there be found any expressed intention of Congress to strip the states of their Eleventh Amendment rights. The purpose behind the Securities Act was to protect investors against malpractice in the securities and financial markets. They were enacted to eliminate and mitigate undesirable practices in the securities field and were aimed at the unscrupulous dealer. See 2 U.S. Cong. & Adm. News 1964, p. 3016.

The Commonwealth in creating a Department of Banking and Securities had basically the same objectives in mind. There is no indication of any Congressional intent to even preempt the states in this type regulation, let alone subject the states to suit in a federal forum for alleged negligence in this activity.

In *Edelman* v. *Jordan,* supra, concerning a state's Eleventh Amendment rights, it is stated:

". . . In deciding whether a State has waived its constitutional protection under the Eleventh Amendment, we will find waiver only where stated 'by the most express language or by such overwhelming implications from the text as will leave no room for any other reasonable construction.' *Murray* v. *Wilson Distilling Co.* 213 US 151, 171, 53 L.Ed. 742, 29 S.Ct. 458 (1909). We see no reason to retreat from the Court's statement in Great Northern Insurance Co. v. Read, 322 US 47, 54, 88 L.Ed. 1121, 64 S. Ct. 873 (1945) (footnote omitted):

" '[W]hen we are dealing with the sovereign exemption from judicial interference in the vital field of financial administration a clear declaration of the state's intention to submit its fiscal problems to other courts than those of its own creation must be found.' "

Congress, by its silence as to the amenability of states to suits in federal courts, cannot be presumed to have conditioned the regulation of securities by a State upon the waiver of its Eleventh Amendment immunity.

The Commonwealth, through its Department of Banking and Securities, undertook to perform a much needed public service (the supervision of financial institutions), a distinctly essential governmental function.

This fact alone distinguishes the instant case from *Parden,* supra, a case upon which appellant places much reliance. In *Parden,* the activity undertaken by the State of Alabama was proprietary in nature, i.e., the running of a state-owned railroad in interstate commerce for pro-

fit. Whereas, in the instant case, the regulation and supervision of financial institutions is an activity strictly governmental in nature.

For this reason, the Sixth Circuit and the District Court correctly found that the Commonwealth, in choosing to provide this needed public service did not voluntarily consent to have claims brought against her as a result of such activities adjudicated in a federal forum (Appendix B and D of Petition).

As Mr. Justice Marshall stated in his concurring opinion in *Employees*, supra.

> "... To suggest that the State had the choice of either ceasing operation of these vital public services or 'consenting' to federal suit sufficies, I believe, to demonstrate that the State had no true choice at all and thereby that the State did not voluntarily consent to the exercise of federal jurisdiction in this case. Cf. Marchetti v. United States, 390 US 39, 51-52, 19 L.Ed.2d 889, 88 S.Ct. 697 (1968). In Parden, Alabama entered the interstate railroad business with at least legal notice of an operator's responsibilities and liability under the FELA to suit in federal court, and it could have chosen not to enter at all if it considered that liability too onerous or offensive. It obviously is a far different thing to say that a State must give up established facilities, services, and programs or else consent to federal suit. Thus, I conclude that the State has not voluntarily consented to the

> exercise of federal judicial power over it in the context of this case." (footnote omitted)

CONCLUSION

Respondent submits that the petition for certiorari should be denied because the federal courts lack the requisite jurisdiction to adjudicate this action against the Commonwealth brought by one of its citizens under the Federal Securities Acts, where the Commonwealth has neither consented to be sued nor waived its Eleventh Amendment immunity from suit in federal court.

In addition, certiorari should be denied because the decisions of the District Court and the Sixth Circuit are clearly correct and there is neither a conflict of decision nor a substantial federal question presented.

In his petition, petitioner cites *MacKethan* v. *Commonwealth of Virginia*, 370 F.Supp. 1 (E.D. Va. 1974); 508 F.2d 838 (4th Cir. 1974), as being similar to this action and all arguments in that case apply to the instant case with equal force. We agree. This Court on June 23, 1975 denied certiorari in *MacKethan*, supra (74-1198; 43 LW 3672)

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, James M. Ringo, one of counsel for respondent, hereby certify that the foregoing Brief for Respondent in Opposition was served on petitioner by depositing copies of same in the United States mail, first class postage prepaid, on July 18, 1975, addressed to James N. Williams, Jr., Esq. Wyatt, Grafton & Sloss, 2800 Citizens Plaza, Louisville, Kentucky 40202, Counsel for Plaintiff-Petitioner Arthur W. Brown; Thomas C, Jacobs, Esq., Department of Banking & Securities, Frankfort, Kentucky 40601, Counsel for Defendant-Respondent Perry R. Miller; W. Scott Miller, Jr., Esq. 602 Louisville Trust Building, One Riverfront Plaza, Louisville, Kentucky 40202, Co-Counsel for Defendant-Respondent E. G. Adams; Merritt S. Deitz, Jr., Esq., Suite 504, 100 North Sixth Street, Louisville, Kentucky 40202, Co-Counsel for Defendant-Respondent E. G. Adams; Leon J. Shaikun, Esq., Marion E. Taylor Building, Louisville, Kentucky 40202, Attorney for Defendant-Respondent Robert L. Musselman; Frank A. Logan, Esq., 504 Kentucky Home Life Building, Louisville, Kentucky 40202, Co-Counsel for Defendant-Respondent Thomas G. Florence; Frank E. Haddad, Jr., Esq., 529 Kentucky Home Life Building, Louisville, Kentucky 40202, Co-Counsel for Defendant-Respondent Thomas G. Florence; William Compton, Esq., Assistant Attorney General, State House Annex, Columbus, Ohio 43215, Counsel for State of Ohio, Amicus Curiae; and Michael Compton, Esq., Smith & Schnacke, 390 Talbott Tour, Dayton, Ohio 45402, Counsel for State of Ohio, Amicus Curiae.

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